

## Chapter 3

# FINANCING OF THE RAILROAD RETIREMENT SYSTEM

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**R**ailroad retirement and survivor benefits are financed by the following sources of income:

1. Payroll taxes on railroad earnings paid by covered employees and employers.
2. Interest on investments of the railroad retirement accounts.
3. Revenues from Federal income taxes on railroad retirement benefits.
4. A cents-per-hour tax levied on employers only.
5. Income from a financial interchange with the social security trust funds.
6. Borrowing from general revenues related to certain features of the financial interchange mentioned in (5).
7. Appropriations from general revenues.

Each of these income sources is described briefly on the following pages.

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**Note.**—On October 1, 1984, a new account came into existence, called the Social Security Equivalent Benefit (SSEB) Account. Certain items of income to the railroad retirement system are credited to that account, and the portion of benefits which is equivalent to social security benefits is charged to that account. The existence of the new account changes only the manner of accounting for income and outgo, but does not change the financing of the railroad retirement system in any way. For this reason, the term “Railroad Retirement Account” can be read as referring to the combined Railroad Retirement and SSEB Accounts.

## **PAYROLL TAXES**

The primary source of income to the Railroad Retirement Account is payroll taxes levied on covered employers and their employees.

The tax rate equivalent to that which would be paid under social security is commonly called the tier I tax. The tier I tax rate of 7.65 percent is divided into 6.20 percent for railroad retirement and 1.45 percent for Medicare hospital insurance. Payroll taxes in excess of the tier I rate are called tier II taxes.

Tier I taxes are ultimately transferred to social security through the financial interchange. The tier II tax is used to finance tier II benefits and also the portion of tier I benefits not reimbursed through the financial interchange.

### **Earnings Base**

The taxable amounts of an employee's earnings are subject to tier I and tier II maximums, which are both indexed to annual increases in national wage levels. The tier I maximum is the same as the social security wage base and is higher than the tier II base as a result of 1977 social security amendments, which provided for a series of yearly increases in the social security tax base that effected corresponding increases in the railroad retirement tier I tax base.

## **INVESTMENTS**

Funds not needed immediately for benefit payments or administrative expenses are invested in interest-bearing securities. The law restricts investments to obligations of the U.S. Government or obligations guaranteed as to principal and interest by the U.S. Government.

Two types of special issues are available to the railroad retirement accounts, called par value specials and market-based specials. A special issue is a Treasury obligation issued directly to the account and redeemed by the Treasury. Sales and redemptions of special issues, therefore, do not affect the securities market.

Par value specials are securities issued by the Treasury directly to the Railroad Retirement and Social Security Equivalent Benefit Accounts, maturing on the first business day of the month following the month of issue. Their yield rate each month is the average yield rate, computed as of the last day of the previous month, of marketable Treasury notes with maturity dates not less than three years away.

Market-based specials include (1) Treasury bills, (2) Treasury notes and bonds with at least 6 months to maturity and (3) Treasury STRIPS with at least 10 years to maturity. The price is the same as the market price, but purchases and sales are made directly with the Treasury, so as not to affect the securities market.

The Board makes projections of the income and outgo of the account. If the amount invested in the par value special is projected as more than is needed for projected benefit payments, and if the Board can find appropriate market-based specials with a higher yield than current and anticipated par value special yields, it redeems the unneeded amounts of par value specials and invests the proceeds in market-based specials maturing at various times.

The Railroad Retirement Board has established an Investment Committee to advise the Board on policy and decisions related to the investment of funds credited to the Railroad Retirement Account and the Railroad Retirement Supplemental Account. The committee meets at least once a month and furnishes the Board a quarterly report of the holdings of the trust funds.

In recent years, the Board has realized substantially higher capital gains from security sales than previously.

## **INCOME TAXES ON RAILROAD RETIREMENT BENEFITS**

Social security amendments in 1983 subjected railroad retirement tier I benefits to Federal income taxes on the same basis as social security benefits, and subsequent railroad retirement legislation subjected benefits over and above social security levels to Federal income tax on the same basis as private and public service pensions, beginning with

taxable year 1984. Revenues from income taxes on tier I, tier II and vested dual benefits are used for benefit payments.

## **SUPPLEMENTAL ANNUITY TAXES**

A supplemental railroad retirement annuity program for career rail employees, instituted in 1966, is financed on a pay-as-you-go basis by a cents-per-hour tax levied solely on employers. The rate of the tax is determined on a quarterly basis by the Railroad Retirement Board. An employer maintaining a negotiated pension plan is exempt from the cents-per-hour tax. Instead, the employer reimburses the Board on an actual basis. Supplemental tax income is credited to a special account, the Railroad Retirement Supplemental Account, distinct from the regular Railroad Retirement Account.

Amendments in 1981 added the requirement that an employee have at least one month of railroad service before October 1981 in order to be eligible for a supplemental annuity. This provision, which phases the program out in the long term, will first begin to affect the required financing of the supplemental annuity program in calendar year 2006.

## **FINANCIAL INTERCHANGE**

### **Purpose and History of Financial Interchange**

The financial interchange between the railroad retirement and social security systems is intended to put the Social Security Old-Age, Survivors, and Disability Insurance (OASDI) and Hospital Insurance (HI) trust funds in the same position they would have been had railroad employment been covered under the Social Security and Federal Insurance Contributions Acts. It follows that all computations under the financial interchange are performed according to social security law. The amount of benefits payable under the Railroad Retirement Act has no effect on the results.

The financial interchange provision was introduced by the 1951 amendments to the Railroad Retirement Act and was made retroactive to January 1, 1937. The initial determination covered the period

from January 1937 through June 1952 and indicated a balance of \$488.2 million in favor of the social security system. Only interest was paid on that amount until the debt was liquidated by subsequent offsets in favor of the railroad retirement system. Since the liquidation of the original balance, annual transfers reflecting the experience of the preceding fiscal year have always favored railroad retirement.

The experience under the financial interchange proved to be more favorable to the railroad retirement system than was originally anticipated. There were two primary causes for this. The first was a series of successive amendments to the Social Security Act which raised benefits immediately while tax increases were deferred. The second factor was the decline in railroad employment, which reduced the taxes payable to social security but had little immediate effect on the benefit reimbursements.

### **Financial Interchange Determinations**

Placing the social security trust funds in the same position they would have been had railroad employment been covered under social security since its inception involves computing the amount of social security payroll and income taxes relating to railroad employment and computing the amount of additional benefits which social security would have paid to railroad retirement beneficiaries during the same fiscal year. In the computation of the latter amount, credit is given for any social security benefits actually paid to railroad retirement beneficiaries. When benefit reimbursements exceed payroll and income taxes, the difference, with an allowance for interest and administrative expenses, is transferred from the social security trust funds to the Railroad Retirement Account. If taxes exceed benefit reimbursements (this has not happened since 1951), a transfer would be made in favor of the social security trust funds.

## **BORROWING FROM GENERAL REVENUES RELATED TO THE FINANCIAL INTERCHANGE**

Financial interchange transfers are made in a lump sum for a whole fiscal year in the June following the close of a fiscal year.

At any time, therefore, there are between 9 and 21 months' worth of financial interchange transfers which in a sense are owed the Board. The Board receives interest on this money, so this practice does no long-term harm to the financial condition of the Railroad Retirement Account. The lag in the transfers, however, periodically caused short-term cash-flow problems in past years.

In order to avoid any further cash-flow problems from this lag, the 1983 Solvency Act provided for monthly loans from U.S. Treasury general funds. Each loan is equal to an estimate of the transfer the Board would have received in the preceding month if the financial interchange with social security were on an up-to-date basis, with interest adjustments. The Board must repay these loans when it receives the transfer from social security against which the money was advanced.

## **APPROPRIATIONS FROM GENERAL REVENUES**

Prior to the Railroad Retirement Act of 1974, concurrent social security benefits (dual benefits) payable to railroad retirement annuitants had a significant effect on the amount of the financial interchange. Consider the example of two hypothetical employees shown on the next page.

The size of the benefits is appropriate to the early 1970's. The employees are assumed to have identical dates of birth, dates of retirement, and histories of railroad earnings. One employee, however, is assumed to have had just enough covered employment under social security to qualify for a social security benefit. (The difference in railroad retirement benefits arises from minor reductions in the 1937 Act formula for receipt of a social security benefit.)

Two conclusions are apparent. First, the employee with benefits under both systems received an advantage over the career railroad worker, which many considered unfair. In the example, the employee who is eligible for social security collects \$80 more than the employee who is not eligible (the difference in line C); while, under a completely integrated system, the social security earnings would have added only \$20 (the difference in line D). Second, because social security

Table 2.--**Example of effects of dual benefits  
on financial interchange**

Item	Employee eligible for social security	Employee not eligible for social security
(A) Railroad retirement benefit	\$380	\$400
(B) Social security benefit	100	-
(C) Total benefit, A + B	480	400
(D) Social security benefit on combined earnings (gross tier I)	240	220
(E) Financial interchange transfer from social security to railroad retirement, D - B	140	220
(F) Amount to be financed by excess of railroad retirement taxes over social security taxes, A - E	240	180

subtracted the social security benefit in calculating the financial interchange transfer, railroad retirement paid most of the cost of these benefits. In the example, this is represented by the \$60 difference in line F.

This situation was a major cause of the poor financial condition of the railroad retirement system in the early 1970's. In order to improve the system's financial condition, the Railroad Retirement Act of 1974 provided that the tier I component of the railroad retirement annuity be reduced by any social security benefit. This essentially integrated the two systems and eliminated the advantage of qualifying for benefits under both systems.

However, it was generally considered unfair to eliminate this advantage entirely for those already retired or close to retirement when the 1974 Act became effective. The 1974 Act, therefore, provided for a restoration of social security benefits which were considered vested at the end of 1974. The restored amount is known as the "vested dual benefit." This benefit was available to qualifying spouses and survivors as well as to qualifying employees. The vested dual benefit was explained in the previous chapter on benefit provisions.

Eventually, after a period of several decades, the vested dual benefit will be entirely phased out.

Under the 1974 Act, appropriations had been authorized from general revenues for the phase-out costs of vested dual benefits. The amounts were to be sufficient to fund (on a level payment basis over the years 1976-2000) the vested dual benefit for new accruals and for beneficiaries on the rolls. The yearly amount was to be reviewed every three years at the time of each actuarial valuation.

The costs of these vested dual benefit payments, which were intended to be funded solely from general revenues, were substantially more than the amount estimated at the time the 1974 Act was passed, and substantially more than the funds that were appropriated between 1974 and 1981. To stop the resulting drain on the Railroad Retirement Account, the 1981 amendments established a Dual Benefits Payments Account. This account is credited with the general revenue appropriations, and it is charged with vested dual benefit payments. The Board is required to adjust vested dual benefit payments from this account so that the amounts paid to annuitants do not exceed the amounts appropriated.

## **FINANCIAL POSITION OF THE RAILROAD RETIREMENT SYSTEM**

The financial condition of the railroad retirement system is closely related to the size of the railroad work force. This is because, as mentioned previously, the primary source of income to the system is the payroll tax on covered employers and their employees. Clearly, a large labor force will generate more revenue for the system than a small labor force. Railroad employment has declined steeply over the years and the drop in employment necessitated the strong corrective action taken in the 1981 and 1983 amendments. In the absence of these amendments, substantial reductions in payments to current beneficiaries would have been required.

The omnibus budget legislation enacted December 22, 1987, increased railroad retirement payroll tax rates in January 1988 by a total of two percent, and it provided for revenues from Federal

income taxes on certain railroad retirement benefits to be transferred to the railroad retirement system for an additional year, fiscal year 1989. Subsequent legislation extended these income tax transfers on a permanent basis.

The Board's recent railroad retirement financial reports to Congress have been favorable. They concluded that, barring a sudden, unanticipated, large drop in rail employment, the railroad retirement system will experience no cash-flow problems for over 20 years; and the Board has not recommended any change in the retirement payroll tax on employers and employees. However, the long-term stability of the system, under its current financing structure, still depends on actual railroad employment levels over the coming years.